UKRAINE LEGAL AND POLICY SUPPORT

DIRECT CONTRACTS IN UKRAINIAN POWER SECTOR

ENERGY IQC TASK ORDER FOR UKRAINE
Contract No. LAG-I-00-98-00005

TASK ORDER 803

Report

Prepared For:

U.S. Agency for International Development

Prepared by:

Hagler Bailly
1530 Wilson Boulevard
Suite 400
Arlington, VA 22209-2406
(703) 251-0300

November 30, 1999

CONTENTS

Table of Contents

I INTRODUCTION

The Ukrainian wholesale power market was created in 1996 as a transitional model that would change when the privatization of the unbundled power sector entities was ready to begin. The existing model requires all generated and imported electric power to be sold to the power exchange (state-owned enterprise called Ukrenergo) and all power purchased on the wholesale market to be purchased from Ukrenergo.

In this transition, a funds administrator was created in accordance with the Energomarket Agreement that required all retail suppliers to create transit accounts into which their customers would pay their electric bills. The transit accounts are cleared each day and the funds are sent to a central clearing account managed Ukrenergo. Ukrenergo is responsible to allocate these daily funds to the power sector entities.

The concept of this funds transfer was to provide a transparent collection of cash from customers and make that cash available to all power sector entities.

In the last year, six oblenergos have been privatized through portfolio investors and several more are scheduled to be privatized in the year 2000 to strategic investors. The Government of Ukraine is also planning the privatization of the four fossil-fired Generation Companies (GENCOs). The potential strategic investors (and even some existing retail suppliers) are requesting/requiring the use of direct contracts between generators and retail suppliers.

II FINANCIAL INSTRUMENTS USED IN ENERGOMARKET

Only a small amount of cash (about 10% of sales) is sent to the clearing account run by the Market Funds Administrator. Most settlements for electricity sold to and purchased from the market are transacted by non-cash. From time to time the Cabinet of Ministers (CoM) of Ukraine takes steps to ban certain forms of non-cash deals, however every attempt is futile. The CoM prohibitions in practice only block the existing methods available for Generators to make settlements for fuel needed to run their power plants. Every attempt to tighten the rules for non-cash settlements makes no impact on cash payments. The next inevitable step from the Ministry of Energy has been to complement the CoM rules with some exceptions, which in time have become a loophole through which almost every entity subordinated to the Ministry can make non-cash settlements.

The entities themselves, together with lobbying for the exceptions, are looking for different ways to evade rules and find new types of non-cash transactions not prohibited in the Civil Code of Ukraine. For example, when the CoM prohibited offsets, debt assignments began to be widely used on the market. When the latter were banned, circulation of promissory notes increased significantly - the promissory notes being issued by almost all oblenergos, generating companies and many big customers.

Due to the reasons described above, the usage of different types of non-cash transactions changes over time. The current situation is characterized by a relatively new form of offsets introduced by CoM resolution #621 of April 19, 1999 which makes offsets through a short-term bank loan (usually one day) rather than making them solely through mutual reduction of receivables and payables in accounting books.

The existing financial instruments are described in more detail in Attachment I..

III BILATERAL FINANCIAL RELATIONSHIPS IN ENERGOMARKET

All forms of non-cash payments are, in essence, direct financial agreements between entities, by which they receive or retain cash in exchange for electricity prices lower than the official tariffs of regulated retail suppliers or higher prices of fuel or equipment purchased with non-cash instruments. The discount rates vary widely, and in almost all cases, remain non-transparent.

The graph shown in Attachment II provides an example of the direct relationships used in Energomarket. These relationships change over time and the graph only represents the financial relationship during November 1999. Other financial relationships, such as debt assignments, were used for several months during the year 1999, but not in November.

In 1997, NERC developed a scheme that would not violate the Electricity Law, but would allow generators to have direct financial relationships with customers. The following are the rules that would allow such relationships:

1. All generators must sell to Ukrenergo, the single buyer in Energomarket, at NERC designated rates (for nuclear, hydroelectric, and CHP plants), at negotiated rates (importers) or at the short-term marginal price (SMP) for fossil Generators.
2. Generators can create non-regulated subsidiaries involved in retail sales.
3. Generator's non-regulated subsidiaries purchase power from Ukrenergo
4. Certain customers, designated by Minenergo, provide compensation to the non-regulated subsidiaries of the Generators.
5. Generators receive compensation in various forms (cash, barter, etc.)
6. Generators inform Ukrenergo of the compensation. Ukrenergo reduces its accounts payable to the Generators by the amount of compensation (in equivalent cash) made by the customers.

The use of direct financial relationships has been in existence for nearly three years. Due to the slowness in the privatization of the power sector, the transformation of the wholesale power market into a more complete market has been delayed. The gimmicks, exceptions, and special arrangements have been arranged in order to bypass the existing wholesale market model. The time has come to privatize the power sector and to create a new wholesale market model so that direct contractual relationships become clear and transparent.

IV IMPLEMENTATION OF DIRECT CONTRACTS

A. Introduction of Direct Contracts

The introduction of direct contracts will require some preliminary work by NERC and the power sector entities. That preliminary work is described in a companion Hagler Bailly report, *Changes For An Effective Wholesale Market Operation In The Next 6-12 Months And Actions Needed To Achieve A Sustainable Market Operation, November 1999*.

Before direct contracts are allowed, the licenses for Retail Supplier will be revised to require additional equipment and financial security. Full payments of all wholesale services will be required. Cash payments will significantly increase or the Retail Suppliers will put their licenses in risk.

The following describes the actions needed to introduce direct contracts. These actions are consistent with the draft WEM law revisions provided by Hagler Bailly to NERC and with the draft revised Energomarket Members Agreement developed by Hagler Bailly.

1. Allocation of nuclear and hydro-electric facilities to retail customers and other wholesale buyers will be based on their last twelve months peak load. This will provide all wholesale purchasers with their fair share of low-cost energy resources.
2. The nuclear Generators will be able to negotiate contracts with their existing customers using Direct Contracts, but in accordance with the following procedures:
   a) All Retail Suppliers and existing customers of the nuclear Generator will be allocated a capacity entitlement into the nuclear Generation.
   b) Entitlement percentages will be based on the peak load share of each wholesale purchaser of the total system peak over the last twelve months.
   c) Each Retail Supplier will be asked whether or not it wants its share of entitlements.
   d) Any entitlement not accepted will be proportionally allocated to the Retail Suppliers requesting additional entitlements.
   e) If there are entitlements not selected by Retail Suppliers, then the nuclear Generators may supply their remaining capacity to the Balancing Market or export it. The price for nuclear direct sales will be capped by NERC

3. The hydro Generators will be able to negotiate contracts with their existing customers, if any, using Direct Contracts using similar procedures to those described for nuclear Generators.
4. Imports can be sold in the Energomarket Balancing Market, to Retail Suppliers, or to non-residential consumers.
5. Each supplier/direct consumer must submit daily and hourly demand forecast for the next day. These forecasts will be used to determine the capacity and energy requirements for each wholesale purchaser. Accuracy in forecasting will be the responsibility of the wholesale purchasers.
6. The Retail Suppliers will develop an hourly forecast of loads for the next day. The Market Operator can reject such a load forecast only if the Retail Supplier does not self-schedule.
7. For those Retail Suppliers wishing to self-schedule with Direct Contracts above their monthly minimum load, the Market Operator will arrange for energy balancing services.
8. Each supplier will be responsible for the imbalance of their supply (scheduled versus actual requirements). Payments, if any, to satisfy this imbalance will depend upon the hourly magnitude of the differences.
9. Direct contracts are permitted for sale and purchases between Retail Supplier and any other entity that has power entitlements.
10. Commercial metering must be in place, paid by the Retail Suppliers and operated and maintained by the High Voltage Network. Each Retail Supplier must pay for their allocated share of communication equipment needed to process market operations data on an hourly basis
11. .Nuclear and hydro-electric generation is provided to the Market Operator at the cost-of-service tariffs provided by NERC.
12. Resources under direct contracts will be used in developing the next day's schedule. These resources will be assumed to be must-run and the schedule can not be modified unless the Operating Procedures allow for a change in a schedule (for example, specific emergency situations).
13. Each supplier (and existing non-residential customer currently purchasing from Retail Suppliers) must provide a line of credit from an international bank equal to two average month's payment relating to the services provided by the Market Operator, the National Dispatch Center, and the High Voltage Network.
14. All power sold under direct contracts will have no impact on the calculation of the price for sales to and from the Balancing Market.

B. Open Competition in Contracting for Wholesale Power

The initial phase of direct contracts will allow for a very structured direct sales contract. It should provide strategic investors of local electricity companies the direct

contracts and direct financial relationships they seek today. That phase will remain until NERC determines that enough competition exists to allow for a completely competitive wholesale electricity market. This will happen when a significant amount of the generation is privately owned by strategic investors and not under governmental control.

1. Generators can sell through competitive bidding into the Balancing Market, or through negotiation of direct contracts with wholesale purchasers or exporters as they please. Retail Suppliers can purchase, as they please, from local generation, purchase from Generators with direct contracts, purchase from the Balancing market, or purchase from importers.

2. NERC has no authority over Generator pricing practices except through the market rules of the WEM Agreement.

3. All price caps and tariffs for Generation energy and capacity are removed.

4. Ancillary services will remain as monopoly services until NERC determines that sufficient competition exists for a particular ancillary service.

ATTACHMENT I

FINANCIAL INSTRUMENTS IN THE UKRAINIAN POWER SECTOR

1. Offsets – the most general form of non-cash payment. A retail customer that provides fuel, equipment or services to a generating company can reduce its payables to oblenergo with simultaneous reduction of oblenergo's payables to Ukrenergo, Ukrenergo's payables to the generating company and the generating company's payables to the retail customer. Sometimes offsets are performed by oblenergos only. These are simpler transactions under which a retail customer provides the oblenergo goods in return for electricity. Since this payment does not go through the Energomarkt, there is little information on this type of offsets.

Currently offsets are limited to governmental agencies that perform various budget offsets (electricity payment for budget financed customers in exchange for different state and local taxes levied on energy entities or governmental subsidies that, instead of being paid to oblast administrations, are paid directly to thermal generators or to coal mines) and centralized payment to nuclear fuel suppliers.

2. Bank offsets. To distinguish between this old offset and the new offset made through banks, the former will be called "book offset" and the latter – "bank offset". This bank offset introduced by CoM resolution #621 became very popular because it facilitates settlements that are not necessarily tied to a single chain of mutual debtors. Another advantage of the new financial instrument is that despite the need to pay for the short term loan, this is cheaper than 20% VAT levied on other non-cash transactions, such as promissory notes and transfer orders. Officially, the "bank offsets" are permitted for settlements between energy, gas, oil and coal industry enterprises, thus they can cover most of the needs of power plants.

3. Transfer Orders. Transfer orders arose upon the promulgation of Cabinet of Ministers Order #487 of May 1997. Before that power plants could engage in give-and-take transactions which effectively were direct electricity sale contracts outside the market. Since the order banned all operations outside the market, a new settlement scheme was invented which formally did not violate this rule, but effectively allowed to continue the give-and take deals. The scheme works as follows: a) A generator purchases from an IES fuel or equipment or services and pays for them in the transfer order that indicates the amount owed by the generator. This transfer order then is given to the IES. b) The IES uses the transfer order as an advance payment to the Energomarket and can purchase electricity at the market purchase price until this advance payment is exhausted. Payment in transfer orders requires 20% VAT payment.

This payment mechanism differs from give-and-take transactions because in case of the latter the generator received direct payment from the IES for so called "fuel processing". This payment sometimes was made even in cash, so, generators were quite satisfied with give-and-take schemes. With the introduction of the new mechanism, generators secured payments that covered only fuel costs. Other costs related to the electricity production had to be covered by

other payments from the market. This has been the main concern of generators, and Minenergo is still considering reintroduction of give-and-take deals. On the other hand, most generators have adjusted to the new system, and according to confidential sources, they, as a rule, continue to get paid the "processing fee", in return for which they value the purchased fuel at a higher price.

In general, the pricing mechanism for transfer orders is less clear than for other barter transactions in the market. Discounts at different stages of the payment chain and uncontrolled valuation allows prices as low as 1 c/kWh.

Since generating companies were allowed to have unregulated supply licenses, all of them created subsidiaries that carry out retail supply. Now, Energoatom is the biggest IES with its market share fluctuating between 16% and 25% of the total retail market.

4. Promissory notes have been widely used for several years since NDC issued its notes in the amount of over Hr. 1b in 1996 and 1997. Because there was no strict regulation and control over promissory notes circulation in Ukraine, the situation in this market was very complicated. In 1998 promissory notes and bills of exchange were issued by almost all energy entities and big electricity customers. Some oblenergos issued promissory notes, even to the amount exceeding their debt, which is considered a criminal offence. During this time NDC's Bills Department (Promissory Notes Circulation Center) complained that NDC could not verify all of them. Even when only NDC promissory notes were in circulation, this center revealed about Hr.13m worth of forged notes.

Currently, electricity payment in promissory notes is regulated by CoM Resolution #622 of April 19, 1999, which restricts such payments to only Treasury bills and promissory notes issued by oblast administrations. Generators' promissory notes can be used on condition of advance cash payment of 30% of their face value.

Payment in promissory notes also requires 20% VAT tax.

Debt assignment. Essentially, this mechanism works in the same way as an offset. The difference is just another legal ground for mutual reduction of debts. Instead of the reduction in accounting books, one party (oblenergo) assigns to a second party (Energomarket) the debt owed to it by a third party (customer), for which the second party has to pay the first party the same amount of money. Then the mutual debts (debt for electricity owed by oblenergo and debt owed by Energomarket to oblenergo resulting from the debt assignment contract) are mutually written off. After that Energomarket assigns the customer's debt to a generator, the generator to an IES, and the IES uses this right do demand debt in its settlements with the customer.

Currently this type of non-cash payment is not used.

Statistics for the first six months of 1999 show the mix of various types of payments

	1st half of 1999			October 1999	
	Hr. thousand	%		Hr. thousand	%
Total generators' receivables	6 132 063	100.00%		1 181 057	100.00%
Cash	495 658	8.08%		55 184	4.67%
Bank offset	787 118	12.84%		606 293	51.33%
Transfer orders	619 880	10.11%		74 404	6.30%
Promissory notes	1 846 870	30.12%			
Book offsets	159 641	2.60%		173 376	14.68%
Offsets through Minenergo	406 381	6.63%		(These items combined)	(These items combined)
		0.00%			0.00%
Non payment	1 816 515	29.62%		271 800	23.01%

The bank offset introduced in April 1999 could not affect statistics for the first six months significantly. But numbers for October show that now this type of non-cash payment allows for over 50% of total receivables to be paid, or 67% of total paid electricity. Even IESs consider this instrument more convenient than transfer orders. The share of transfer orders shrank from 10.1% to 6.3%.

Financial Settlements in EnergoMarket